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What Future for the Eurozone? Combining Discipline, Solidarity and Institutional Reforms

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This Policy Brief discusses the challenges that await policymakers in reforming the EMU. A balance between discipline and solidarity will have to be found, while institutional reforms should improve the eurozone's legitimacy and efficiency. The key decisions on EMU reforms will have to be made during the 2014-2019 parliamentary term, as the window of opportunity for major reforms is likely to be closed afterwards.

The introduction of the euro was one of the most important steps in the European integration process. The eurozone crisis has shown, however, that the EU's Economic and Monetary Union (EMU) had several flaws in its design. Over the past years, an important reform process has taken place, which is likely to continue in the future.

The question can be raised: "what does the future hold for the eurozone?" The answer to this question will depend to a large extent on the policy choices that will be made during the European Parliament's 2014-2019 term. In this respect, the 2014 European elections will matter a great deal for the future shape and strength of the EMU.

A wide range of possible reforms of the eurozone has been advocated since the outbreak of the sovereign debt crisis. Some are pessimistic about the ability of certain countries to recover from the crisis and advocate a eurozone break-up, judging the common currency a failed experiment. More optimistic voices believe the eurozone should instead move forward, by mending its birth defects. Where most agree is that maintaining the architecture of the EMU in its present fragile state would leave it vulnerable to future crises.

Besides calls for reforms to make the eurozone sustainable in the long-term, policymakers will also be faced with the need for short-term decisions to genuinely exit the ongoing crisis. Fiscal and macroeconomic imbalances will have to be addressed, and additional solidarity might be needed to cope with the severe social toll in the countries most hit by the crisis. Insufficient economic growth or renewed periods of crisis could complicate the situation even further.

Without doubt, any discussions on the reforms of the EMU are bound to be difficult for Member States and the European Parliament. In essence, European Council President Herman Van Rompuy identified the four building blocks around which the eurozone reforms will evolve, involving (i) financial, (ii) budgetary, (iii) economic and (iv) legitimacy and accountability reforms. These four building blocks provide a sense of direction with regard to the areas where reforms are needed. However, this approach does not necessarily highlight the underlying challenges that the reforms will face. In this respect, this paper identifies three crucial challenges for the upcoming reform of the EMU.

The first two challenges relate to the substantive rules and instruments of the EMU ("*what*" the EMU is about). A first challenge is ensuring sufficient discipline in the conduct of policies that are of vital importance to the eurozone's sustainability. This is to prevent the economic, fiscal and financial imbalances that occurred prior to the crisis. The discipline will likely have to be counterbalanced by solidarity across eurozone countries, which is the second challenge in the EMU reforms. Often, specific policymakers put the emphasis either on discipline or on solidarity. In reality, these two elements tend to be balanced against each other: discussions will have to consider both.

Besides the "what" of the EMU, a properly functioning eurozone will also require addressing the "*how*" question. This boils down to defining *how* the EMU's institutional functioning should be organised. Organising the EU's legal and governance frameworks will be key in this respect, as well as defining the relation between the eurozone and the other Member States.

In what follows, we will discuss each of the three challenges in turn.

ENSURING DISCIPLINE

A sustainable monetary union needs more than a mere common monetary policy. It notably requires sound fiscal and economic policymaking, as well as a stable financial sector. Prior to the crisis, these three policies were largely decided at the level of the individual Member States, with the EU having little ability to discipline national policymaking. As the eurozone crisis revealed substantial deficiencies in each of these policy fields, the European level had to strengthen its grip on all of them. Yet, the degree of European control differs from one policy field to another, resulting in distinct challenges for each of them over the 2014-2019 parliamentary term.

Public Finances

The rules promoting discipline in public finances have traditionally been the most developed part of the EMU's economic arm. A Stability and Growth Pact was put in place to regulate public finances. Even so, the rules were not able to prevent lax fiscal policies in several Member States. To counter this weakness, the eurozone's fiscal rules have been considerably strengthened, *inter alia*, via the so-called six-pack and two-pack legislation packages and an intergovernmental treaty known as the Fiscal Compact.

The degree of strictness and flexibility in the application of the fiscal rules will be a key issue during the next parliamentary term. It remains to be seen to what extent Member States will be willing to respect the pace and scale of envisaged fiscal consolidation. The response of the EU to deviations from fiscal objectives by a Member State will be closely watched. In essence, European policymakers will have to find a balance between two distinct approaches. They could, on the one hand, opt for a strict, mechanical application of the rules. This would offer the advantage of clarity, but a too rigid application would undermine the legitimacy of the EU's rules and actions. The alternative is a more flexible application of the EU fiscal rules. By considering the specific circumstances such an approach would allow for more economic and political judgement. The risk is, however, that this discretion might lead to the same laxity as was seen prior to the crisis.

A similar balance will have to be found in terms of sanctions for the non-respect of the European rules. Applying a sanction would worsen a country's fiscal problem, but the lack of sanctions as a possible stick would weaken the rules' credibility. A potential way to overcome this predicament is to foresee positive incentives for troubled Member States to carry out the necessary reforms, making the sanctions part of a wider package (see the section on solidarity).

As the EU's framework of fiscal rules was put in place in the midst of a full scale sovereign debt crisis, Europe is likely to benefit from a review of its rules during calmer times. The envisaged assessment by 2018 of whether the Fiscal Compact should become an integral part of regular EU law offers a good opportunity for such an examination. The review can assess the fields in which a more flexible approach is warranted. A possible course of action in this sense is allowing for more attention for public investment when applying the EU fiscal rules – in line with the traditional meaning of the golden rule for fiscal policy. Alternatively, a review might result in increased European powers to discipline fiscal policies. While even stricter fiscal rules do not seem desirable, future reforms could give the EU more powers in the national budget making process. In this respect, the EU could potentially be given a veto right over draft national budgets.

Economic Policy

Before the crisis there was little willingness in the Member States to grant the EU a large role in economic policymaking, which was thus limited to surveillance and non-binding recommendations. The Europe 2020 Strategy, which replaced the Lisbon Strategy, is the cornerstone of this non-binding approach. The lack of more compulsory European control proved problematic, as large economic imbalances between eurozone countries emerged.

As a consequence, several reforms were introduced to increase the EU's role in economic policymaking. This notably led to the introduction of the Macroeconomic Imbalance Procedure. Despite this evolution, it still seems the EU lacks the instruments to compel a Member State to revise its economic policies at an early stage, i.e. before problems result in large economic weaknesses. During the next parliamentary term, a discussion is set to take place on a further strengthening of the EU's role in economic policymaking.

Some argue for endowing the EU level with its own economic policymaking powers. In ambitious views this would result in a "European economic government". Inevitably, such increased European powers would limit to a large extent national sovereignty in economic policymaking and would have to be coupled with sufficient political legitimacy at the EU level.

A somewhat less ambitious – but more likely – step in the direction of more European control may come from the introduction of "contractual arrangements" between the EU and each individual eurozone country. In such contracts, the EU and the Member State would agree on the economic reforms that a country will undertake in subsequent years. The EU's aim is that the contractual nature of the document will lead to higher compliance than is the case for the EU's existing recommendations. Importantly, the contracts would be linked to a form of solidarity for countries that implement the agreed reforms.

Beyond the question of the degree of control the EU should have on economic policy, a crucial question is the type of economic policies that the European level should actually advocate. The EU's approach is at times criticised for being overly oriented on structural reforms and for insufficiently enforcing a symmetric adjustment involving not only the most vulnerable but also the most competitive eurozone countries. Others insist that the EU should pay more attention to social policies (see Frank Vandenbroucke, 2014). Economic policy is to a large extent determined by political choices. Hence, the outcome of the European and national elections can have a determining influence on the EU's position with regard to economic policymaking.

The Financial Sector

Over the years, financial regulation has become largely determined at the EU level, even though national differences persist. The financial sector itself has increasingly transcended national borders. Supervision of the sector had not followed this trend, as it remained a national prerogative. The same holds true for the management of problems and crises in the financial sector.

As for fiscal and economic policymaking, the eurozone crisis has demonstrated the weaknesses of this system. National supervisors paid insufficient attention to the inter-linkages in the European financial sector and cross-border supervisory cooperation was flawed. When problems occurred, the cost of bailing out banks proved very large for some Member States, leading to questions about their own solvency.

This approach to financial supervision and crisis management will be radically altered with the launch of a European Banking Union. The European control over the financial sector will actually be stronger than its control over fiscal and economic policies. From November 2014 onwards, a Single Supervisory Mechanism (SSM) will be in place in which the eurozone and potentially other Member States will participate. Supervision of the banks in the SSM will be jointly exercised by the national supervisors and the European Central Bank (ECB), with the latter having the final say on supervisory decisions. In terms of crisis management, a similar system will be put in place through the creation of a Single Resolution Mechanism (SRM).

In normal times, exercising these competences is essentially the responsibility of independent supervisors. Hence, it lies mostly outside of the hands of the European Parliament and national governments. The European co-legislators will nonetheless play an important role in the success of the Banking Union, as they are to provide an environment in which the project can be effective.

The latter will require putting the necessary solidarity instruments in place (see infra). In addition, policymakers will have to work towards strong, harmonised rules for the banking sector. If the national rules differed considerably across Member States, the different legal frameworks would create tremendous complications for the work of the European level supervisory and crisis management authorities. As part of the regulatory response to the financial crisis, legislators will also have to deal with the structure of the banking sector and its too-big-to-fail problem. Finally, a timely review of the functioning of the Banking Union is called for during the 2014-2019 period. This will notably include assessing the interaction between the national supervisors and the ECB, the Banking Union's membership conditions for non-eurozone countries, as well as the envisaged crisis management procedures.

PROVIDING SOLIDARITY

The content and scope of solidarity instruments to consider for the EMU represents a second challenge for policymakers. As a complement to fiscal, economic and financial discipline, several measures implying the sharing of sovereign risks between eurozone countries will continue to be debated. Some solidarity mechanisms could bring partial relief to the public debt deleveraging process of the eurozone. Other instruments may facilitate the economic adjustment-process taking place in countries most badly hit by the crisis. More immediately, concrete steps involving solidarity are to be discussed in the setting-up of the Banking Union.

Reducing Debt Levels beyond Austerity

Eurozone policymakers developed several new instruments and policies to deal with the sovereign debt crisis. A European Stability Mechanism (ESM) was created, which can provide loans to eurozone countries that are no longer able to access financial markets at affordable rates. The real turning point in the eurozone crisis, though, was the declaration by ECB President Mario Draghi over the summer of 2012 that the ECB would do "whatever it takes" to save the euro, and the subsequent introduction of the Outright Monetary Transaction (OMT) programme. Since then, sovereign yield spreads have considerably narrowed which led many to claim the eurozone debt crisis was effectively over.

However, as the 2014 judgement of the German Constitutional Court on the OMT illustrated, the ECB intervention is still vehemently opposed in Germany, the eurozone's largest economy. Critics of the ECB notably claim that the institution acts beyond its mandate by directly financing Member States, thereby providing illegal financial assistance and undermining discipline. The debate on the degree of risk sharing and solidarity necessary in the case of eurozone countries facing the risk of losing access to financial markets is hence far from conclusive, and will likely remain so in the years to come. Yet, given the extreme challenge that public debt reduction entails for many eurozone countries, repeated calls from the most distressed Member States for new arrangements involving solidarity are bound to continue.

Discussions on what ought to be the role of the ECB in mitigating sovereign debt risks will remain central. Given the ECB's independence and its mandate enshrined in the EU Treaties, the scope for steering monetary policy will be limited. Common debt emissions by the eurozone countries, dubbed "Eurobonds" in the past, may also come back to the forefront. Large scale projects for Eurobonds have been opposed by creditor countries, but perhaps smaller scale types of Eurobonds could be discussed. The conditionality and the type of support from the ESM will also be the focus of discussions if eurozone countries require help once again. In countries with high public debt, political and social forces pushing for radical ways of reducing their debt burden – i.e. debt restructuring or partial defaults – may gain ground in years to come.

In a shorter time perspective, a more concrete issue will be the situation of countries still under a European bailout programme. Eurozone leaders will notably have to decide whether debt relief and new financial assistance should be granted to Greece. In this case, a so-called "Public Sector Involvement" would imply that past official loans from other eurozone countries are not entirely reimbursed, which *de facto* amounts to increased solidarity.

Economic Shock Absorption

Numerous economists have argued that the single currency lacks a European-level mechanism to deal with "asymmetric economic shocks", i.e. shocks that hit a specific part of the eurozone. A European shock absorption mechanism would allow to compensate for a part of the economic and social consequences in the countries that are hit the hardest by a crisis.

A modest instrument to compensate for economic shocks will be on the table of policymakers as soon as the 2014-2019 term gets going. If the contractual arrangements discussed above would be introduced, they are to be accompanied by a "solidarity mechanism" that may involve grants or, less ambitiously, cheap loans to Member States. It is clear that this solidarity mechanism would be limited. It might compensate for some of the political and economic costs of carrying out reforms, but it would not be able to play a substantial role in dealing with large economic shocks. The solidarity attached to the contractual arrangements could, however, provide a step-up to a more sizable form of solidarity in the future.

A genuine and sizeable economic shock absorption mechanism would allow for transfers between countries of the monetary union, for example to address differentials in economic output or unemployment owing to such shocks. Such an instrument requires a specific budget at the eurozone level. This eurozone budget should in principle be backed by a "fiscal capacity" (i.e. have its own revenues) and possibly be coupled with a borrowing capacity (i.e. the ability to issue common European debt). While a shock absorption mechanism might be advocated by several economists, politically it remains a very controversial issue. Behind the technicalities of the possible instruments, what is essentially at stake is the desirable scope of transfers within the EMU. Many fear that such transfers would become permanent despite claims of the contrary. Others believe transfers may be conceivable in a European Social Union (Vandenbroucke, 2014).

Hence, any shock absorption mechanism involving major reforms could only be considered as a long-term prospect. A substantial step in this direction will remain controversial – and will require political sacrifices. Yet, without additional solidarity instruments in the EMU architecture, the emphasis will continue to lie on the fiscal and economic discipline of each individual Member State. As a result, all the burden of the adjustment is borne by the countries that are hit the hardest by a crisis. Limiting the support coming from the rest of the eurozone to loans in case of major financial distress may prove insufficient in the delicate balance to strike between discipline and solidarity in the EMU.

Joint Management of Financial Crises

After the 2014 elections, solidarity in the banking sector will be both a short-term and a long-term issue. In the short-term, an assessment by the ECB might detect weaknesses that cannot be addressed by a bank itself or the individual Member State in which the bank is based. In such a scenario, European solidarity would be required, most likely by making use of the European Stability Mechanism.

Once the Banking Union is fully operational, the need for a common approach during financial crises will become even bigger. The reason is that the pooling of supervisory responsibilities implies that member countries of the Banking Union will also have to deal jointly with problems in their banking sector. This inevitably calls for long-term European solidarity, in the form of risk-sharing instruments. Three types of instruments will be discussed during the 2014-2019 parliamentary term.

In the first place, a European resolution fund is to be financed by levies on the banking sector. A genuinely common European resolution fund will only be put in place over the course of several years. This slow pace and the relatively small size of the eventual fund are expected to be put under scrutiny during the years to come.

While the new regulatory framework tries hard to prevent this, it might prove unavoidable that public money will be used to deal with a systemic bank crisis. That is why a second element in the debate on cross-border solidarity concerns the potential need for a European common public "backstop". Such a backstop is to provide public financial resources for crisis management when no other realistic alternatives are left. The conditionality of this backstop, its size and the date of entry into force will all be major food for discussions.

Finally, the question of an EU-level common deposit guarantee is likely to be raised in the future. The idea is that such a common guarantee would cover deposits in all Banking Union countries, replacing the existing national deposit guarantees schemes. It might contribute to financial stability by preventing massive bank runs in one specific country during a crisis. Despite its potential advantages, it is unsure whether the common deposit guarantee will be politically acceptable. While it would render the Banking Union more stable, it might also result in sizable transfers across national borders.

Managing the Institutional Set-up

After having discussed the balance between discipline and solidarity, we now turn to the question of how the functioning of the EMU should be organised. In dealing with the institutional issues of the EMU, two interlinked goals will have to be considered, namely the quests for efficiency and legitimacy of the EMU.

In the past, policymakers would refer to the need for a "political union" to deal with these issues. As of 2014, there is more reluctance to call upon this concept. Instead people refer to the need for "accountability" in the EMU. The difference in semantics perhaps reflects a decreased willingness to take large steps in this field. The institutional question remains nonetheless crucial as it forms the basis that will enable the elements of discipline and solidarity in the EMU discussed above.

A Eurozone Treaty?

A first institutional issue that will probably be high on the agenda during the next legislative term revolves around the legal framework of the eurozone. An essential question is whether additional reforms should take place inside the EU's legal framework or on an intergovernmental basis. Both forms have their own advantages and problems. Using the EU's legal framework might involve changing the existing Treaties, implying a complex and hazardous decision-making procedure. In contrast, an intergovernmental approach that takes place outside the EU legal framework is easier to agree on. However, the latter procedure makes it more difficult to rely on the EU Institutions. In addition, intergovernmental Treaties are not allowed to override the EU's own Treaties and thus do not offer a way around the EU Treaties' limitations.

As Philippe de Schoutheete (2014) describes, the widespread reluctance to Treaty changes seems to gradually make place for openness to reconsider the EU's primary law. While still not certain to happen, this evolution makes Treaty modifications that revise the functioning of the eurozone a genuine possibility. Nonetheless, ensuring the ratification of a Treaty change in all Member States would be a most difficult endeavour.

When considering the scope of Treaty change for the eurozone, Member States basically have the choice between an extensive and a narrow approach. An extensive approach to Treaty reform would consist in reconsidering all Treaty articles relevant to the EMU. This allows for a structural modification of the eurozone's functioning, but comes with high political risks as it would open Pandora's box in terms of multiple and diverging national demands. In contrast, a Treaty reform with a narrower scope would involve only a limited set of amendments to Treaty articles. These amendments would concern specific Treaty obstacles, so as to open up the possibility for reforms that are desired by some. This might concern the full separation of bank supervision and monetary policy, the introduction of some form of Eurobonds, and a revision of the EMU's corrective procedures. Such a narrow scope approach might be somewhat easier to implement, but it would not allow for a radical overhaul of the eurozone's functioning – which is perhaps needed.

Eurozone Specific Decision-making

In terms of the reform of the EU institutions, the most important consideration for the EMU will likely be the extent to which a separate decision-making framework for the eurozone should be put in place. Linked to this question is the degree of involvement of the non-eurozone countries. Such differentiated decision-making, combined with closer economic integration of some Member States, would lead to a further increase in the EU's multi-speed and multi-tier integration. Discussions on eurozone specific decision-making will have to take into account the specificities of each of the EU's institutions.

In the Council of Ministers and the European Council, a eurozone/non-eurozone separation has already occurred to a certain degree. With regard to the heads of state and governments, Euro Summits take place in addition to the ordinary European Council meetings. The Eurogroup only gathers eurozone finance ministers and functions as a body that informally prepares all Council decisions related to the eurozone. To increase the importance and efficiency of the Eurogroup, Germany and France are considering endowing it with a full-time president based in Brussels. As the Eurogroup's informal role is embedded in the Treaty, a formal decision-making role for the body would require changing the EU's Treaty framework.

In the European Parliament, there has been more resistance than in the Council to distinguish between eurozone and non-eurozone members. The cohesion of the Parliament is deemed to be at stake. At the same time it might make little sense to give to MEPs from the UK or Poland the same say on the eurozone as MEPs from the eurozone itself, which is the case today. Differentiation between general parliamentary activities and activities specific to the eurozone would almost certainly involve setting-up a eurozone subcommittee in the European Parliament. The precise design of such a eurozone committee would raise difficult questions, both with regard to the participation and the voting rights of non-eurozone countries. In the short-term, some steps towards a eurozone subcommittee could already take place. A legislative role for such a committee would, once again, require a Treaty change.

With regard to the Commission, making a distinction between Commissioners that originate from a country from the eurozone and those from other Member States seems very unlikely. Alternative approaches may strengthen eurozone decision-making. One option is to merge the function of President of the Eurogroup with the position of Commissioner for EMU affairs. Another possibility is to have several "junior" Commissioners that are each responsible for a specific part of the EMU, with one "senior" Commissioner taking the lead on

EMU affairs. This latter option would simultaneously deal with the large number of Commissioners.

For the European Central Bank, the key institutional reform would be to endow non-eurozone countries with an equal say on decision-making on bank supervision as the eurozone countries. This would require a Treaty change. The same holds true for any modification to the institution's monetary mandate.

Transcending the EU level, the eurozone countries could also modify their role in decision-making in international organisations, such as the Bank for International Settlements (BIS) and the International Monetary Fund (IMF). Some argue that the eurozone countries should replace their individual national representations with common representation. Several eurozone countries, however, do not seem ready to give up their seat in these organisations. Closer collaboration between eurozone countries' representations could be a compromise between these different views.

Governance Procedures

During the 2014-2019 parliamentary term, the economic governance procedures are expected to be scrutinised, including the procedures that have been put in place during the eurozone crisis.

A key governance element that might face future parliamentary scrutiny is the procedure for economic and fiscal policy coordination, which is centred on the European Semester. The overall procedure is already seen by practitioners as highly demanding administratively. If the proposed contractual arrangements would simply be added to the existing procedures, this would further increase this complexity – potentially damaging effectiveness. Policymakers will therefore have to consider how new instruments can be integrated in current policy coordination without unduly increasing the administrative workload. In addition, a reduction of the yearly workload could consist in lifting some reporting requirements out of the European Semester and replacing them with multi-annual programming (in line with the contractual arrangements). The annual governance procedures could then focus on the most important economic adjustments.

Besides the annual "regular" governance procedure, the crisis governance in case of bailout programmes for countries, involving the "Troika" (the ECB, the Commission and the IMF), might be revised. Some argue for a reduction of the role of the ECB in the bailout programmes, while others plead for the replacement of the existing European Stability Mechanism with a proper European Monetary Fund. The latter is meant to fully substitute the "Troika" with another governance structure to deal with bailout programmes.

In terms of legitimacy and national ownership of the economic governance procedures, the involvement of the European parliament and its national counterparts could also be reconsidered. The role of the parliaments has for the most part been limited to legislative work, with little involvement from parliaments in the governance procedures. Different ways to improve their role can be considered, such as voting on EU recommendations and national commitments in the relevant parliaments. The evolution of the Inter-parliamentary Conference on Economic and Financial Governance, which brings together members of the European parliaments and of national parliaments in application of the Fiscal Compact, will be of particular relevance. However, increased involvement of parliaments will have to be balanced with the need to ensure the procedures' efficiency.

CONCLUSION

This Policy Brief discussed three challenges that await policymakers in their efforts to reform the eurozone: ensuring enough discipline, counterbalancing it with solidarity and enhancing the institutional workings of the eurozone. The challenges of discipline and solidarity are typically distinctively championed by different sides around the negotiating table. Yet, both discipline and solidarity are necessary for the eurozone to be successful. Therefore, discussions on the future of the EMU should not result in minimalist compromises. Instead, additional instruments ensuring discipline should necessarily be coupled with an increase in the scope of instruments for solidarity, and the other way around.

The third and final challenge of the EMU consists in the establishment of a proper institutional framework for the eurozone. This is needed to provide the foundation for addressing the first two challenges. Some of the more ambitious reforms in terms of discipline and solidarity call for changes to the EU's Treaty framework. In particular, the institutional organisation will need to ensure the legitimacy and efficiency of the EMU, which requires a reflection on the governance procedures and the degree of eurozone specific decision-making.

By 2019, when the next European elections will be held, the debate in Europe will be very different from the current election debate. By then, the eurozone crisis may be conceived as something of the past. Unless a new similar crisis occurs, we cannot expect future politicians to have a particular sense of urgency in reforming the EMU. Hence, any envisaged comprehensive reform decisions for the EMU will have to occur during the 2014-2019 parliamentary term. This should convince all political parties that will participate in the European elections of May 2014 to spell out their vision for the future of the eurozone. A crucial test awaits us in the next five years: turning ideas for the EMU into reality. If successful, the eurozone countries are likely to reap the benefits of the single currency. If not, they might once more face the consequences of its incomplete and fragile construction.

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